



Examination Technique Seminar on Section A (Case)

- December 2013 and June 2014

Module C Business Assurance



Past Paper Review

DECEMBER 2013 SECTION A

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MC – December 2013 Case



Superior Electronic Limited (“Superior”) is a company listed on The Hong Kong Stock Exchange and is engaged in the manufacturing and trading of electronic products with production facilities in mainland China, Vietnam and Africa. ABC & Co. (“ABC”) is the auditor of Superior and you are the partner in charge of the audit.

[Listed company] + [Multi-location] + [Electronic products]

MC – December 2013 Case



During the financial year ending 31 December 2013, Superior announced the following significant events:

- 1. In February 2013, Superior's factory in Africa was flooded because of the intermittent rainfall since January 2013. Due to difficulties in accessing the facility because of the evacuation order issued by the local government, Superior has suspended production in Africa since 15 February 2013. The factory building was flooded and it was difficult to predict when production could be resumed.**

[Special Event during the year] – Suspension of African production

MC – December 2013 Case



The financial information related to the factory in Africa extracted from its audited financial statements for the year ended 31 December 2012 was as follows:

	HK\$'000
Property, plant and equipment	75,228
Inventories	23,410
Trade and other receivable	12,450
Bank balances and cash	5,211
Trade and other payables	11,524

MC – December 2013 Case



2. In March 2013, Superior was informed that some bank balances of a subsidiary company in Africa were queried by the branch manager of the company's local bank because a large quantity of bank notes were deposited into the company's bank account instead of a cheque receipt. With concern about involvement in money laundering activities, an independent non-executive director of Superior voiced out in a monthly board meeting that Superior's internal audit function should be strengthened, in particular to monitor the risk assessment process of the company.

**[Unusual event – plenty of cash deposited into the bank]
[Internal audit in the company – about Corporate Governance]**

MC – December 2013 Case



3. In May 2013, Superior entered into an agreement to subcontract the manufacturing process to a company which is owned by a director of Superior with an annual consideration not exceeding HK\$200 million.

[Significant related party – HKSA 550 (Clarified)]

MC – December 2013 Case



In the course of planning for the audit of Superior for the year ending 31 December 2013, ABC obtained the management accounts from Superior. The financial information extracted from the management accounts is as follows:

	Nine months ended 30 September 2013 (unaudited) HK\$'000	Year ended 31 December 2012 (audited) HK\$'000
Revenue	1,134,617	1,814,896
Cost of sales	(1,185,084)	(1,652,456)
Operating expenses	(45,928)	(99,820)
Impairment of property, plant and equipment	(62,000)	0
(Loss) / profit for the period/year	(158,395)	62,620

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	30 September 2013 (unaudited) HK\$'000	31 December 2012 (audited) HK\$'000
Property, plant and equipment	480,228	612,334
Inventories	76,523	120,221
Trade and other receivables	250,895	321,852
Bank balances and cash	240,111	245,223
Trade and other payables	128,552	249,541
Bank and other borrowings	13,456	18,478
[Consider material increase or decrease]		

MC – December 2013 Case



Question 1 (22 marks – approximately 40 minutes)

a) In respect of the flood damage to Superior's factory in Africa, identify and explain the risks of material misstatements at assertion level.

(10 marks)

[HKSA 315 (Revised) – which item in the FS and what assertions ?

b) What are your suggested audit procedures in addressing the risks identified in Question 1(a)?

(12 marks)

[HKSA 330 (Clarified)] – Audit procedures – mainly tests of details



DECEMBER 2013 SECTION A

Q1 Answer

MC – December 2013 Case



Answer 1(a)

The following are the risks of material misstatements identified at assertion level:

1) *Existence and valuation of property, plant and equipment* ***[Tips : Consider items in Statement of Financial Position first]***

- The amount of property, plant and equipment is material to financial statements, it represents **12%** of the total property, plant and equipment of Superior as at 31 December 2012.
- The flood damage may affect the usability of these assets and their recoverable or **realisable value**. **[Fair value dropped]**
- The assets may be overstated because the register includes assets that have been sold or scrapped and are not removed from the register. **[Valuation assertion – ie incorrect]**

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Answer 1(a) (Cont'd)

2) *Existence and valuation of inventories*

- The amount of inventories is material to financial statements, it represents **19%** of the total inventories of Superior as at 31 December 2012.
- The inventories may not be valued **at the lower of cost or net realisable value.**
- The inventories may be overstated if those scrapped during the flood are not removed from the inventory listing.

[Items must be material]

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Answer 1(a) (Cont'd)

3) *Valuation of insurance claim*

- With reference to the value of property, plant and equipment of the factory, the amount of **the insurance claim** should be material to the financial statements.
- The amount of insurance claim recognised depends on the assessment of the damage by the insurance company.

[Involve accounting estimate – contingent assets]

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Answer 1(a) (Cont'd)

4) *Completeness of the compensation loss to employees*

- The operation of the factory was suspended after the flooding and the entity may need **to lay off the excessive workers** so as to reduce the operating costs.
- The amount of compensation may be understated if the entity has not fully accrued for compensation according to the statutory requirements.

[Liabilities to pay the employees – therefore completeness]

MC – December 2013 Case



Answer 1(a) (Cont'd)

5) *Completeness of potential liability*

- The possible claims from customers in respect of the late delivery of goods or default in delivery of goods may be understated.

[Liabilities to customers – completeness]

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Answer 1(b)

In response to the **existence and valuation of property, plant and equipment**, the following procedures should be considered:

- Perform **physical inspection** of the existence and condition of property, plant and equipment on the year end date. **[Very difficult!!!]**
- Obtain the valuation report from **experts** on the usability and fair value of those affected assets. **[HKSA 620 (Clarified)]**
- Evaluate the competence, capabilities and objectivity of the experts of the valuation report to consider whether their work is adequate for the audit purposes. **[HKSA 620 (Clarified)]**

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Answer 1(b) (Cont'd)

- Check the **records** of the disposal of property, plant and equipment after the flooding so as to assess the recoverable value if any. **[Obtain documents]**
- Evaluate the **adequacy** of the impairment assessed by the management of Superior. **[Accounting estimate – reasonable ?]**

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Answer 1(b) (Cont'd)

In response to the **existence and valuation of inventories**, the following procedures should be considered:

- Perform **inventory count** on the year end date. **[Very difficult!!!]**

[Consider alternative procedures]

- Check the **subsequent selling prices** of inventories for the net realisable value.
- Evaluate **the adequacy** of impairment recognised for the inventories.

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Answer 1(b) (Cont'd)

In response to the **valuation of the insurance claim**, the following procedures should be considered:

- Obtain a copy of the insurance policy.
- Evaluate the coverage of the policy.
- Inspect the correspondence with insurance company for the claim.
- Check the claim received records for the validity of the claim income recognised.

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Answer 1(b) (Cont'd)

In response to the **completeness of compensation loss** to employees, the following procedures should be considered:

- **Discuss with management** if they have any lay off plan. If so, check the minutes or related documents for approval and details.
- Obtain the calculation of compensation from the management of the entity. **[Re-performance]**
- Check the formula with reference to the statutory requirements.
- Check the payments of calculated compensation to employees.
- Check the acknowledgement of receipt.

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Answer 1(b) (Cont'd)

In response to the **completeness of potential liability**, the following procedures should be considered:

- Check the breakdown of legal expenses for any claims.
- Seek direct communication with the external legal counsel through a letter of inquiry. **[HKSA 501 (Clarified)]**

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Question 2 (8 marks – approximately 14 minutes)

For an organisation such as Superior, what are the roles of the **internal audit function in risk management**? As an audit client, what factors do you consider when you set up the internal audit department in relation to risk management? Briefly explain your reasoning and expectations behind the factors you considered.

(8 marks)

[Consider Corporate Governance]



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Q2 Answer

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Answer 2

The internal audit function has a two-fold role in relation to key risk management:

- **monitoring** the organisation's **overall risk management policy** to ensure it operates effectively; and
- monitoring the **strategies** implemented to ensure that they continue to operate effectively.

A significant risk management policy in companies is to implement internal controls, and internal audit has a key role in assessing systems and testing controls.

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Answer 2 (Cont'd)

The key consideration factors in building an internal audit function capable of carrying out the roles and duties related to risk management include:

Factors for consideration	Reasoning or expectations
Retains objectivity	<ul style="list-style-type: none">• generally not be involved in the assessment of risks and the design and implementation of the system; and• reporting directly to the audit committee or the Board of Directors.
Requires sufficient competence, including skills and experience , in the organisation's business systems	<ul style="list-style-type: none">• meet the technical expertise and experience requirements to carry out the roles and duties of monitoring.

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Answer 2 (Cont'd)

Factors for consideration	Reasoning or expectations
Requires sufficient manpower resources meeting business scale and continuity/ contingency needs	<ul style="list-style-type: none">• the monitoring process is a continual process rather than a one-off exercise; and• the internal audit function should have an appropriate size to meet the requirements related to volume and locations of workload.

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Question 3 (10 marks – approximately 18 minutes)

- a) Identify and explain the risk of material misstatements relating to the **disclosure of the related party transactions**.

(2 marks)

[ie Lack of disclosure]

- b) Suggest the **audit procedures** you would perform on related party transactions related to the subcontracting fee.

(8 marks)



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Q3 Answer

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Answer 3(a)

The following are the risk of material misstatements identified:

Completeness of disclosure of related party transactions:

- Superior may **not identify all transactions** with related parties according to HKAS 24.
- There is a risk that Superior has not disclosed all related parties and relevant information **in the financial statements** as required

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Answer 3(b)

HKSA 550 (Clarified) Related Parties deals with the auditor's responsibilities with regards to related party relationships and transactions in an audit of financial statements.

The audit team should update their **understanding** of the related party transactions of Superior including relevant **internal controls** and accounting procedures, by inquiry, observation, examination and performing a walk-through test.

Then the audit team **should evaluate the design effectiveness of the controls and identify those key controls** which can mitigate the risks of material misstatements at the assertion level.

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Answer 3(b) (Cont'd)

Validate the operating effectiveness of the internal controls and accounting procedures over the related party transactions during the year:

- The entity **maintains a listing of all related parties**. The finance head is responsible for ensuring the list is updated with any **changes** and changes are **communicated** in a timely manner.
- All transactions with related parties are **approved** by the board of directors of Superior.

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Answer 3(b) (Cont'd)

The audit team should also consider performing the following substantive procedures:

- **Obtain from management a list** of related parties and transactions with related parties.
- Send **confirmations** to related parties for the transactions and balances.
- Review the list and determine, based on your knowledge of Superior, whether they have been properly disclosed in the financial statements in compliance with accounting standards for related party transaction, i.e. **HKAS 24**.

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Answer 3(b) (Cont'd)

- Review **prior year's working papers** to identify known related parties and any previously identified related party transactions.
- Inquire as to the **affiliation of directors and officers** with other parties having business dealings with the company.
- Review **the company's statutory records** to identify any related parties and transactions with these parties.
- **Inquire of other auditors** currently involved in the audit, as to their knowledge of additional related party transactions.

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Answer 3(b) (Cont'd)

[Apply to case]

The subcontracting fee of HK\$200 million is **outside Superior's normal course of business** as the amount is **significant** and involves only one single party. The auditor should also perform the following:

- **Inspect** the underlying contracts or agreements.
- Evaluate whether the **business rationale** of the significant related party transactions suggests they may have been entered into to engage in **fraudulent financial reporting** or to conceal misappropriation of assets.
- Evaluate whether the **terms of the transactions** are consistent with management's explanations.

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Question 4 (10 marks – approximately 18 minutes)

In February 2014, due to a shortage in materials, Superior shipped some raw materials from its African factory to Vietnam to meet the production demand of a high value purchase order. Some cartons of raw materials received by the Vietnam factory were found to contain only the packaging materials. The value of the **missing raw materials was estimated at HK\$5 million**. The Chief Executive Officer (“CEO”) of Superior was very angry. He undertook an investigation of this incident and had the following initial findings for the auditors:

- the loss appeared to take place **during** the time of shipment and the identity of the thief is not known at this moment

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- the loss did not appear to be caused by the non-functioning of the internal controls of the African and Vietnam factories
- the raw materials were related **to purchases after the year end** and insurance has been purchased such that the company's financial loss was minimal
- the audited financial statements for the year ended 31 December 2013 should not be revised as such

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You are the audit manager of ABC. You completed the audit of Superior satisfactorily and your engagement partner signed the clean opinion auditor's report before you received the briefing by the CEO of Superior about the inventory loss in Vietnam. The auditor's report has not been sent to shareholders yet.

Required:

As a pre-meeting before meeting the CEO, **prepare your notes** to discuss with your engagement partner the **subsequent event** and list out the **audit procedures** you would recommend to re-assess the impact on the **auditor's report**.

(10 marks)



DECEMBER 2013 SECTION A

Q4 Answer

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Answer 4

Subsequent events are events occurring between the date of the financial statements and the date of the auditor's report and facts that become known to the auditor after the date of the auditor's report.

HKSA560 (Clarified) Subsequent Events provides guidance to auditors in the area. The objectives of the auditor are:

- to obtain **sufficient appropriate audit evidence** about whether events occurring between the date of the financial statements and the date of **the auditor's report that need adjustment or disclosure** in the financial statements are appropriately reflected in the financial statements in accordance with the applicable financial reporting framework.

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Answer 4 (Cont'd)

- to **respond appropriately** to facts that become known to the auditor after the date of the auditor's report which may have caused the auditor to amend the auditor's report if they were known to the auditor at the date of the report.

The **loss of inventory is a subsequent event**. The event may not be significant in monetary terms but it is **significant by nature** especially when the exact cause and details are not known yet. It is also unclear if the event should be an adjusting or a non-adjusting event although comments from the company management related the loss of inventory to purchases after the year end date.

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Answer 4 (Cont'd)

Auditors have a responsibility to identify subsequent events and consider if sufficient and appropriate audit evidence have been obtained. In this case, the auditors are required to **verify the facts provided by the company's management** and assess the impact of the event. To discharge the responsibility, we need to perform the following audit procedures:

- **discuss** the matter with management and those charged with governance;
- consider the **impact on the company's internal controls** and the previous audit **risk assessment** on assertions related to inventory;

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Answer 4 (Cont'd)

- perform **additional responsive audit procedures** if the auditor's reliance on company internal controls was considered to be improper by new information resulting from this event;
- determine **whether the financial statements require amendment**, including both numbers and disclosure, and inquire as to how management intends to address the amendment; and
- if the management **does not amend** the financial statements while required, we **should discuss with the management** and consider alternative ways to communicate with the shareholders.

Module C Business Assurance



Past Paper Review

JUNE 2014 SECTION A

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MC – June 2014 Case



High-Resolution International Holdings Limited (“High-Re”) or “the Group” is a listed company in Hong Kong and a manufacturer and distributor of television and related products. The Group develops and produces different ranges of television of their own brands and OEM products. High-Re has three main manufacturing plants in Shenzhen, Mexico and Poland. As at 31 December 2013, High-Re has about 80 trading subsidiaries serving their customers in over 30 countries.

[Listed Company] + [Manufacturer] + Group + Multi-locations

MC – June 2014 Case



In a 2013 High-Re press release, Chairman Szeto forecasts that the world demand for television and related products will triple in the next two years in view of the coming sport events such as the World Cup and Olympics. In order to capture the market and meet the increase in demand, High-Re has put **additional effort into developing a wider range of new models** to meet different customers' needs. High-Re has also acquired a **few smaller scale production plants** in different locations both inside and outside mainland China to enhance the Group's production capacity. Specifically, High-Re plans to further expand its business to South America and has set up two trading offices in Sao Paulo and Mexico City.

[Aggressive business strategy]

MC – June 2014 Case



As at 31 May 2014, High-Re's inventory balance increased by **35%** comparing to 31 December 2013. **Research and development expenses increased by 70%** for the first five months of 2014 compared to the same period in the previous year.

Extract of the financial information of High-Re for the five-month period ended 31 May:

US \$'million	2014	2013
Revenue	1,400	1,350
Cost of sales	1,323	1,280
Gross profit or GP%	5.5%	5.2%
Net(loss) / profit margin	(15)	30

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Key statement of financial position items as at 31 May:

US \$'million	2014	2013
Property, plant and equipment	167	155
Inventory	488	363
Trade receivables	500	580
Trade payables	583	593
Cash and bank balances	54	124

Apart from business expansion, the Group has set clear business objectives **to raise overall efficiency**, not just focusing on utilising the Group's production capacity. The Group's utilisation of production capacity is approximately **65%** which is an all time low in recent years and relatively low compared to other industry players.

[Current low production capacity]

MC – June 2014 Case



In order to gradually improve the Group's overall efficiency, High-Re **has outsourced its payroll function to a third party service provider** during the year. High-Re maintains only minimal resources in the payroll function to oversee the work performed by the third party service provider.

You are Andy Chan, the lead partner of the High-Re audit engagement. You will have a planning meeting with your team soon to prepare for the upcoming High-Re annual audit. Nancy Yu is the new audit manager assisting you in this audit.

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Question 1 (12 marks – approximately 22 minutes)

- a) Explain the characteristics of “risk-based”, “transaction cycle” and “top-down” audit approaches.
- (6 marks)
- b) Assuming you are Andy, which audit approaches above would you adopt for the High-Re audit? Explain your reasons for selecting such audit approaches and elaborate on them.
- (6 marks)

[Can you use all or either two or only one ?]



JUNE 2014 SECTION A

Q1 Answer

MC – June 2014 Case



Answer 1(a)

The “risk-based” audit approach relies on analysing audit risk into **its component parts** (inherent risk, control risk and detection risk) and then choosing the **appropriate volume** of audit procedures to reduce detection risk to the level necessary that audit risk is at an acceptable level.

The analysis of risk is usually **performed by a more experienced auditor** with more time spent on this work. Once the risk analysis is performed, **less** time is expected to be spent in the **substantive auditing**.

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Answer 1(a) (Cont'd)

The **“transaction cycle” approach** focuses on testing the transactions which have occurred, resulting in the entries in the statement of profit or loss and other comprehensive income or statement of financial position.

By adopting the “transaction cycle” approach, usually **a sample of transactions are selected and tested to ensure that each transaction was complete** and processed correctly throughout the cycle. Through the “transaction cycle” approach, the transactions that appear in the financial statements are substantiated.

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Answer 1(a) (Cont'd)

The “**top-down**” approach, sometimes known as **the business risk approach**, starts with a high level view of the business and its objectives.

This approach is targeted at **high level controls** and reduces the amount of substantive testing.

The “top-down” approach is usually adopted in **larger size entity** audits, such as those of multinational corporations.

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Answer 1(b)

High-Re is a corporation with businesses operating in a numerous locations. High-Re has over 80 trading subsidiaries in over 30 countries, 3 major manufacturing plants in mainland China, Mexico and Poland and the headquarters in Hong Kong.

High-Re is classified as a **multinational corporation**.

Therefore, adoption of the **“risk-based, top-down” audit approach** is usually more effective and efficient than the “transaction cycle” approach as the “risk-based, top-down” audit approach focuses on **high level controls and extensive use of analytical procedures**.

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Answer 1(b) (Cont'd)

In addition, by adopting the “risk-based, top-down” audit approach, Andy can add more value to High-Re as the approach focuses on the **business as a whole** and a lower engagement risk of being sued by having a broader understanding the Group’s business objectives and through observing the Group’s business and control environment.

A “**risk based, top-down**” approach is focused on the **control environment and corporate governance** rather than the detailed transactions tested under the “transaction cycle” approach.

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Answer 1(b) (Cont'd)

Analytical procedures are used more heavily in a business risk approach as they are **consistent** with the auditor's desire to understand the entity's business rather than to substantiate the figures in the financial statements.

The **combined use of the test of controls and analytical procedures**, particularly the higher use of analytical procedures will result in a lower requirement for detailed testing, although substantive testing will not be eliminated completely.

MC – June 2014 Case



Question 2 (18 marks – approximately 32 minutes)

Assume you are Nancy and you are now performing the **preliminary analytical review** based on the financial information of the Group up to May 2014 provided by management. Andy has asked you to pay particular attention to the **asset quality** and to discuss with him any risk of material misstatements identified.

You arranged a meeting with High-Re's Chief Financial Officer ("CFO") and discussed with him the **increase in the inventory balance**. The CFO explained to you that historically the electronic market performs better in the second half of the year than the first half. They have experienced sales teams and a detailed sales strategy to promote the new models. However, when you reviewed the inventory aging, the aging profile has significantly deteriorated compared to December 2013. [**Fluctuations identified**]

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Required:

- a) In light of the results of the preliminary analytical review performed and your discussion with the Group's CFO, suggest **the risk of material misstatements** identified relating to inventory and property, plant and equipment. Elaborate your answers.

(6 marks)

[HKSA 315 (Revised) – items given but no assertions]

- b) In response to the risk of material misstatements relating to inventory identified in Question 2(a), propose and explain your audit procedures.

(6 marks)

[HKSA 330 (Revised) - AP not consistent – what shall you do?]

MC – June 2014 Case



- c) The preliminary analytical review indicated that **research and development expenses increased by 70%** for the first five months of 2014 compared to the same period in the previous year. In response to the risk of material misstatements relating to research and development expenses, explain your audit consideration and planned audit procedures for the research and development expenses, focusing on **recognition of research and development expenses** in terms of **occurrence and cut-off** as well as the presentation and disclosure requirements pertaining to the relevant accounting standards. **[Very high material increase] – think about capitalisation of intangible assets !!**

(Note: Marks will only be given on your explanation about the audit consideration and procedures. No marks will be given on elaborating the relevant accounting standards.)



JUNE 2014 SECTION A

Q2 Answer

MC – June 2014 Case



Answer 2(a)

The risks of material misstatements identified include:

The inventory balance may potentially be **overstated** and that may impact the **valuation assertion** of the inventory balance. As the television industry is **highly affected by technology advancement**, obsolete inventory is a relatively more serious problem than in other industries.

Though management are **optimistic** about market demand and confident in their marketing strategy, the deterioration in inventory ageing and the disproportionate increase in inventory compared to increases in sales are indicators that there may be increasing risk of slow moving and obsolescence inventory.

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Answer 2(a) (Cont'd)

In addition, since **the gross profit margin** percentage for television products is relatively **low** (i.e. 5%), any subsequent fluctuation in the selling price may impact the net realisable value of the Group's inventory. **(Therefore valuation is wrong)**

There may be potential **impairment** of the group's property, plant and equipment that may impact the **valuation assertion** of the Group's property, plant and equipment.

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Answer 2(a) (Cont'd)

The **under-utilisation** of the group's production facilities, the fact that the Group has turned from profit-making to loss-making during the year, and the **continuous expansion** of the Group's production facilities may imply that the Group **will not be able to realise the economic benefits** of the property, plant and equipment through operational use.

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Answer 2(b)

In response to the **risk of overstatement of inventory** value, the proposed audit procedures include:

- Obtain the inventory provision (**Account estimate**) **analysis from management** and discuss with them the provision basis.
- Understand and evaluate the **reasonableness** of the management's inventory provision policies.
- Evaluate the **reasonableness** of the management's provision assessment and **test the data** used in the management's inventory provision analysis.

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Answer 2(b) (Cont'd)

- Understand and evaluate if the management has put in place any specific automated and manual **controls for inventory provision**.
- Test the operating effectiveness of the management's controls over the assessment of inventory provision:
 - (i) validate whether **management controls exist** for the review and approval of the inventory provision by appropriate levels of management and those charged with governance; and

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Answer 2(b) (Cont'd)

- (ii) validate whether the inventory provision is derived from the routine **processing of data by the entity's accounting system** (e.g. provision is determined by making reference to inventory ageing and with an appropriate inventory provision set-up applied across the Group).
- Perform **analytical procedures over the inventory at year end**, e.g. compare the finished goods to the **turnover ratios** of current and prior years, to decide whether if the inventory level is reasonable.
 - Review and test the **inventory ageing analysis** prepared by the management.

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Answer 2(b) (Cont'd)

- Review **subsequent** sales and compare them with the management's sales plan derived from the sales strategy.
- Trace inventory items to **post year-end sales** to determine the realisable value of inventory.
- Develop a **point of estimate or a range** based on independent data to assess the appropriateness of the inventory provision.

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Answer 2(c)

The research and development expenses (“R&D expenses”) increased by **70%** for the first five months of 2013 compared to the same period in the previous year, which **did not increase proportionately with sales. (Fluctuations!!!)**

There may be risk of misstatements in that the R&D expenses may not be incurred and have been overstated.

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Answer 2(c) (Cont'd)

In response to the risk of material misstatements relating to the R&D expenses, the following planned audit procedures should be carried out:

- Understand and evaluate the **management's controls** over the R&D expenses, in particular, the controls over expense approval and journal entry posting.
- Perform validation of controls to ensure the operating effectiveness of those management controls in place.

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Answer 2(c) (Cont'd)

- Obtain a **detailed breakdown of the R&D expenses** and ask the management as to the **reasons for the increase** in the R&D expenses in the year.
- Perform **analytical procedures** such as comparing the level of R&D expenses for this year with previous years.
- Review the **voucher register** for large or unusual items.
- Check the R&D expenses recorded in the general ledger or cash journals to support documents such as **approved requisition forms and supplier invoices** to ensure all the R&D expenses are valid and recorded in the appropriate financial year.

MC – June 2014 Case



Answer 2(c) (Cont'd)

- **Ensure last year accruals** are not expenses again in the current year.
- R&D expenses usually mainly consist of **staff costs**; examine **personnel records and employment contracts** to verify each individual remuneration. **(Consider payroll as well)**
- Perform analytical procedures such as comparing payroll expenses with prior years.
- Check the calculations of **remuneration by re-computing.**

MC – June 2014 Case



Answer 2(c) (Cont'd)

- Scrutinise **monthly payroll records** and investigate unusual items, if any.
- Understand, evaluate and validate the **management's control over the payroll cycle** if there are separate processes and controls for the payroll expenses.
- Confirm that there is no expense which should be capitalised development costs conform to **HKAS 38 criteria** by inspecting details of projects and discussion with technical managers.

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Answer 2(c) (Cont'd)

- Consider the related **presentation and disclosure** requirements on research and development expenses in accordance with **HKAS 38** e.g. the aggregate amount of research and development expenses, including all expenditure that is directly attributable to research and development activities, recognised as expenses during the period should be disclosed.

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Question 3 (14 marks – approximately 25 minutes)

The manufacturing plant in Mexico contributes **20%** of the production of the Group on an annual basis. It carries one third of the Group's inventory balance and **20%** of the Group's property, plant and equipment. The general manager of the Mexico manufacturing plant was appointed by the headquarters' management. The general manager has over 20 years of experience in managing production and extensive knowledge of the television market. The finance controller is a local Mexican lady who worked in one of the international accounting firms specialising in tax for over 5 years.

[Significant component]

MC – June 2014 Case



The manufacturing plant has been **audited by another accounting firm, M&A CPA Limited (“M&A”)**, over the past five years. Apart from being the local statutory auditor of the Mexico plant, M&A is also their tax representative. There were over **10 audit adjustments** reported by M&A in last year’s group audit report. Half of the adjustments were **tax-related matters**.

Andy is satisfied with M&A’s audit quality except for the late submission of the report from M&A that delayed the audit progress at the consolidation level. **Andy is considering taking over** the Mexico manufacturing plant's audit from M&A for group audit purposes. Andy’s accounting firm does not have any office, joint venture or affiliate in Mexico. Andy asked Nancy to give her views on his proposal.

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Required:

- a) Assume you are Nancy, write an analysis to Andy on his **proposal of taking over** the Mexico audit from M&A. Explain the factors to be considered and your stand on his proposal.
- (7 marks)
- b) Assume that M&A is considered to be technically competent and independent after your preliminary assessment, and that Andy decides to continue involving M&A in the group audit, should the Mexico plant be considered as a significant component? What audit procedures should be considered from the group engagement team's perspective?
- (7 marks)



JUNE 2014 SECTION A

Q3 Answer

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Answer 3(a)

Factors that Andy should consider on **taking over M&A's work** on auditing the Mexico manufacturing plant include the following:

(Consider acceptance procedures in HKSA 600 (Clarified))

- **Resources** – whether the group engagement team has sufficient staff resources for the site fieldwork in Mexico.
- **Team competency** – whether the group engagement team has sufficient experience and knowledge for taking up the audit.
- **Language barrier** – whether the language would be a barrier for the group engagement team to communicate with the local management.

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Answer 3(a) (Cont'd)

- **Knowledge of local law and regulations** – whether the group engagement team has sufficient knowledge to understand the local laws and regulations and the potential implications.
- **Taxation** appears to be a complicated area and audit adjustments were raised in the prior year's audit. The group engagement team should consider if they have sufficient understanding and knowledge of the local tax laws.

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Answer 3(a) (Cont'd)

- **Local management** may not support these ideas as they may be audited twice.
- Group management may not support the arrangement as there may be **additional out-of-pocket expenses** incurred e.g. travelling and accommodation expenses.

If I were Nancy, I would advise Andy **not to take** on the Mexico manufacturing plant audit.

This is because the group engagement team is unlikely to possess sufficient understanding over the local laws and regulations.

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Answer 3(a) (Cont'd)

In particular, there were **numerous audit adjustments** raised relating to tax. Taxation may be regarded as **a significant risk** for the local audit. The group engagement team may not have sufficient knowledge and experience in identifying the tax issues and this would expose the group engagement team to a higher audit risk.

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Answer 3(b)

HKSA 600 (Clarified) requires that the group engagement team shall formulate **an overall group audit strategy**, develop **a group audit plan** and conduct ongoing reviews to monitor progress against audit objectives.

The Mexico plant is considered to be a **significant component** as it contributes over 20% of the production of the Group.

It also carries a **significant portion of inventory**, and **property, plant and equipment** of the Group that have been identified with risk of material misstatements.

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Answer 3(b) (Cont'd)

The inherent risk for a manufacturing plant is usually **higher** with more complex procedures and controls around the procurement and manufacturing process.

Since the Mexico plant has been identified as significant component, the group engagement team should have **more involvement** in the Mexico plant audit in terms of **nature, timing and extent**. The group engagement team may perform the following procedures:

- **Meet with the general manager and financial controller** of the Mexico plant or the M&A engagement team to obtain an **understanding** of the Mexico plant and its environment.

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Answer 3(b) (Cont'd)

- Assign a **component materiality** to M&A or agree with M&A an appropriate component materiality from a group audit perspective.
- Review M&A's **overall audit strategy and audit plan.**
- Perform **risk assessment procedures** to identify and assess the risk of material misstatements at the Mexico plant level. These may be performed with the component auditor or by the group engagement team.

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Answer 3(b) (Cont'd)

- **Discuss** with M&A or the general manager and financial controller of the Mexico plant the business activities that are significant to the group and the audit procedures to be carried out.
- **Discuss** with M&A the susceptibility of the component to material misstatement of the financial information due to fraud or error, by considering fraud risk factors.
- Review M&A's documentation of identified significant risks of material misstatements. This may be in the form of a memorandum, including the conclusion drawn by M&A.

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Answer 3(b) (Cont'd)

- Consider **significant audit findings** reported by M&A and additional audit procedures if necessary.
- Obtain **written management representation** from M&A.

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Question 4 (6 marks – approximately 11 minutes)

In response to the recent change in High-Re's payroll function, what **audit procedures** would you consider regarding the payroll expenses?

(6 marks)

[Consider HKSA 402 (Clarified) Service Organisation]



JUNE 2014 SECTION A

Q4 Answer

MC – June 2014 Case



Answer 4

The auditor should perform or consider the following audit procedures for Hi-Re's payroll function:

- Work with management to understand the processes and controls in place with the **third party service provider** over the payroll activities performed for High-Re.
- Evaluate and validate the **operating effectiveness of the controls** in place over the payroll activities performed for High-Re by the third party service provider.

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Answer 4 (Cont'd)

- Understand, evaluate and validate the **management's control and review over the work performed by the third party service provider.**
- Ask management if an **auditor's report** is available to confirm the operating effectiveness of the controls in place with the third party service provider over the payroll activities performed for High-Re.

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Answer 4 (Cont'd)

- Consider a **substantive test approach** if the controls in place with the third party service provider over the payroll activities performed for High-Re is proven to **be ineffective** or a **substantive test approach** itself is more effective and efficient.
- Substantive test procedures include employee contract review, re-performance of the payroll calculation, agree payments with bank statements, etc.



Common hot topics for MC Dec 2014:

- **Corporate Governance and ethics**
- **Client acceptance procedures**
- **Risk assessment and Audit procedures**
- **Fraud and accounting estimate**
- **Internal audit and expert**
- **Going concern**
- **Auditor's report**
- **IT**



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Common Techniques to pass MC



- A. Prepare your critical files**
- B. Only need 1 set of notes**
- C. Time yourself**
- D. Start practice writing**
- E. Don't just copy – use key words for application**
- F. Demonstrate logical thinking – sometimes no right or wrong**
- G. No need to highlight everything in the question booklet**
- H. Writing – legible to read**

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→ Practice past papers and other ETC questions

Only got 2 months left – What shall you do?

- Do past papers with updated answers
- Practice writing out:
Progress test + Exam Pack (2 additional tests) + Final Mock
- Write as many questions out as possible
- Practice using your critical file
- Time yourself

Final Advice



The time to look-up the textbook is limited during an open-book exam

Students should:

- ✓ have a good understanding of the topics before going into the exam
- ✓ read the case and questions carefully
- ✓ answer what is being asked, not what they wanted to be asked
- ✓ identify the core issues of the question and allocate their time accordingly
- ✓ analyse the facts of the case and apply the tax rules or principles to arrive at the conclusion
- ✓ not copy large passages from the textbook
- ✓ use logical thinking to understand and respond to the questions